

Options to Balance Social Security Funds Over the Next 75 Years

by Virginia P. Reno and Joni Lavery

Summary

Social Security is in excellent financial shape over the next decade; it is running surpluses while the rest of the federal government is running deficits. If the Trustees' "best estimates" for the next 75 years hold true, Social Security funds will fall short of benefit costs in about 2042. In that year, taxes coming in will be sufficient to pay 73 percent of benefits promised under current law. Many options are possible to ensure that all legislated benefits can be paid. This brief explores a variety of changes that eliminate all or part of the shortfall. Removing the cap on wages subject to Social Security taxes – now \$90,000 – would bring in enough new money to eliminate the deficit. Price-indexing the benefit formula would reduce benefits enough to erase the deficit. Many combinations of changes would remedy the projected shortfall for 75 years and beyond. The brief also notes how proposals to create individual Social Security accounts differ from plans to bring about long-term solvency.

In the near term, Social Security is in strong financial shape. The program is taking in more revenue than it is paying in benefits over the next decade and beyond. But over the full 75 years used to measure long-term solvency, revenues are projected to fall short of benefit payments. If these long-term projections hold true, it will be necessary to raise revenues or lower benefits at some time in the future in order to balance the system. This Brief summarizes Social Security finances and the size and timing of the projected shortfall. It then describes various options that policymakers could adopt to bring the system into long-term balance. Each option shows how much of the long-range shortfall it remedies, according to the "best estimate" projections of the Social Security Trustees.

Social Security Finances

Workers and their employers pay for Social Security through earmarked Social Security taxes. Workers pay 6.2 percent of their earnings up to a cap of \$90,000 in 2005; the cap rises each year with average wages. Employers pay an equal amount, so the total Social Security tax rate is 12.4 percent. No future increase in the tax rate is scheduled. Part of the income taxes higher-income beneficiaries pay on their benefit income is also earmarked for Social Security.

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The Near Term

In the near term, Social Security is taking in more in taxes than it is paying out in benefits. In 2004, income to the trust funds from taxes and interest on accumulated reserves was \$657.7 billion, while outgo was \$501.6 billion, leaving an annual surplus of \$156.1 billion (OCA, 2005a). In contrast, the rest of the government ran a deficit in 2004 of \$567 billion (CBO, 2005). By law the Social Security surpluses are invested in U.S. Treasury securities that earn interest that goes to the trust funds. The invested funds are, in effect, loaned to the rest of the government. The Treasury has a legal obligation to redeem the securities when needed to pay future benefits. Trust fund outgo covers benefits to retirees and their dependents, widows, disabled workers and their families, and young families that receive survivor benefits when a working parent dies. Outgo also includes administrative costs, which are less than 1 percent of benefit payments.

The Long Term

According to the Trustees' intermediate or "best estimate" projections, Social Security tax revenue will exceed benefit payments until 2018. After that, interest income on the trust fund reserves along with tax revenue will cover costs until 2028. Between 2028 and 2042, the reserves will be drawn down to supplement tax revenue and interest to meet benefit obligations. When the Treasury pays interest on the trust fund investments and ultimately redeems the securities, the rest of the government will need to meet those obligations by raising taxes, cutting spending, or borrowing money from the public. When all of the Treasury securities have been redeemed in 2042, tax revenue is projected to cover 73 percent of benefit costs. The system will not be "broke" in that Social Security taxes will keep coming in. But, if this projection holds true, policymakers will need to increase income or lower benefit obligations in order to ensure that all legislated benefits can be paid. What do other projections show? Under the Trustees' "high cost" scenario, Social Security trust fund reserves would be depleted in 2031 instead of 2042; under their "low cost" scenario, Social Security is solvent for 75 years and beyond. The Congressional Budget Office has issued its own long-range forecast, estimating that Social Security will be solvent until 2052 – a decade longer than the Trustees' best estimate (CBO, 2004). The difference among projections reveals the inherent uncertainty of predicting what will happen in 30, 40, or 50 years.

Size of the Deficit

The "actuarial deficit" is a way to measure the status of Social Security over the next 75 years in a single number. According to the Trustees' best estimate in 2004, the actuarial deficit is 1.89 percent of taxable wages. This means that the gap in Social Security finances would be closed if taxes were increased by 1.89 percentage points immediately. If workers and employers each paid 0.95 percent more, or 7.15 percent of wages instead of 6.2 percent, the system would be in balance for 75 years. This is not to suggest a tax rate increase to eliminate the deficit. It is simply a way to summarize the size of the shortfall¹.

The Congressional Budget Office estimates the deficit is only about half as big. In this case, Social Security would be in long-term balance if workers and employers immediately paid 6.7 percent instead of 6.2 percent of wages (CBO, 2004).

This Brief uses the Trustees' "best estimate" projections to show the fraction of the long-range deficit that various options remedy.

Individual Accounts and Solvency Proposals

Proposals to set up individual private, or personal, accounts as part of Social Security are not included in this brief because such proposals, by themselves, make no independent contribution to the long-term solvency of Social Security. To the extent that such plans would shift funds from scheduled Social Security taxes to personal accounts, they deplete funds that are needed to pay benefits to today's beneficiaries and those who will become beneficiaries in the near future.

Individual account plans change the *form* of Social Security – from a social insurance system in which benefits are defined in law to a system of personal accounts in which people get out what they put in, plus investment gains and minus investment losses and administrative costs. The Academy's 2005 report, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*, explores differences between property and social insurance and examines, in depth, questions about how funds might be paid out of individual accounts if they were to become part of Social Security.

Long-Range Solvency Options

To balance Social Security finances over the next 75 years will require either raising revenue or cutting benefits, or a combination of both steps. Revenue-raising options include lifting the cap on earnings subject to Social Security taxes, raising the Social Security tax rate either now or in the future, and earmarking other taxes for Social Security. Ways to cut benefits include raising the age for full retirement benefits, cutting benefits across the board, price-indexing the benefit formula, and lowering cost-of-living increases. Other proposals would extend coverage to uncovered workers or change investment policies of the trust funds. The options described in this brief are summarized in Table I. Many other variations and combinations of solvency options are possible.

Raising the Tax Cap

The maximum wage base for paying Social Security taxes is \$90,000 in 2005. Only earnings up to \$90,000 are taxed and counted toward workers' future benefits. Currently, 6 percent of all workers earn more than the cap. Earnings above the tax cap now account for 15 percent of the aggregate pay of all workers who pay into Social Security, and are expected to rise to 17 percent of aggregate pay over the next decade (OAct, 2005b). The current benefit for one who always earned the maximum amount and retired at age 65 in 2005 is \$1,874 a month, or about \$22,500 a year.² The benefit replaces about 25 percent of the worker's taxable earnings (OAct, 2004).

Option #1

If all earned income above \$90,000 a year was taxed, but those earnings did not count toward benefits, Social Security would be solvent. Making this change in 2005 would bring in enough revenue to remedy 116 percent of the financing shortfall over the next 75 years. With this change, workers who earn far more than the tax cap would pay considerably more in taxes. For example, a person making \$400,000 a year would pay \$19,220 more and his or her employer would pay a matching amount, for a total increase of \$38,440. The maximum benefit would be no higher than under current law. Ever since Social Security began, the level of wages that are taxed has been linked to the level of wages that count toward benefits. This proposal would break that link.

Option #2

If all wages above \$90,000 were taxed and counted toward benefits, the change would almost make Social Security solvent. This option would remedy 93 percent of the financial shortfall. While high earners and their employers would pay considerably more, these top earners would also receive higher benefits. For example, one who had paid taxes on lifetime earnings of \$400,000 would get a benefit of about \$6,000 a month, or \$72,000 a year, which would replace about 18 percent of the worker's earnings. One who had average lifetime earnings of \$1.0 million a year would get a monthly Social Security benefit of about \$13,500 a month, or \$162,000 a year, which would replace about 16 percent of that worker's earnings. These estimates assume that the existing benefit formula would apply to all earnings above \$90,000. An historical rationale for having a maximum cap on earnings that count toward benefits is to avoid "extending Social Security coverage to a level where forced saving is unnecessary and where the provision of additional retirement income is best left to private saving and pensions" (Advisory Council on Social Security, 1979).

Option #2a

If all earnings above the cap were taxed and counted toward benefits, policymakers could decide to change the benefit formula to replace a smaller portion of top earnings above the old cap, as a way to avoid paying very high Social Security benefits. The current formula is based on workers' average indexed monthly earnings (AIME) in three brackets. In 2005, Social Security pays:

- 90 percent of AIME up to \$624, plus
- 32 percent of AIME between \$624 and \$3,760, plus
- 15 percent of AIME over \$3,760

A modified formula might apply the 15 percent bracket only up to the old cap, and then provide a smaller replacement, say 3 percent of earnings, above that. In this case, the third bracket of the above formula would be modified to:

- 15 percent of AIME between \$3,760 and \$7,500, plus
- 3 percent of AIME above \$7,500

With this change, a worker with average lifetime earnings of \$1.0 million a year would receive a benefit of \$4,400 a month or \$52,800 a year, which would replace about 5 percent of his or her earnings.

Option #3

Traditionally, the Social Security tax cap has covered 90 percent of the aggregate earnings of covered workers. That was true when the program began and it was true in 1983, when Congress last addressed Social Security finances (Ball, 2004). Since then, salaries of top earners have risen faster than the pay of workers who earn below the cap, so that now 85 percent of the total pay of covered workers is taxed. If, over the next decade, the cap gradually rose to encompass 90 percent of all earnings and those higher taxable earnings are counted toward benefits using the current law formula, these changes would remedy 40 percent the long-range financial shortfall. At 2005 wage levels, a cap that encompasses 90 percent of aggregate covered wages would be about \$145,000 (OCAAct, 2005b).

If this new cap were in place today, the maximum amount of the 6.2 percentage point Social Security tax for the employee and employer, each, would be \$3,410 higher. The tax on

maximum wages would be \$8,990 for workers and employers, for a total of \$17,980, compared with the current combined maximum of \$11,160.

Extending Coverage

Almost all workers pay into Social Security. The main exception is the roughly 25 percent of employees of state and local governments who are covered by alternative pension systems, and whose employers (the state or local governmental entities) have chosen not to provide Social Security coverage to their employees (U.S. Ways and Means Committee, 2004). When Congress last extended coverage in 1983, it brought all newly hired federal employees into Social Security and ended the option for state and local governments to opt out of coverage.³

Option #4

If all newly hired state and local employees were brought into Social Security coverage during a five-year phase in period, this change would reduce the long-range shortfall by about 10 percent (Ball, 2004). The change improves long-run finances slightly because the newly covered workers start to pay into Social Security immediately. Ultimately, these workers will also receive benefits.

Many advisory groups have recommended this change to achieve more nearly universal coverage under Social Security and to provide seamless coverage for workers who change jobs. The 1996 Advisory Council on Social Security recommended such an extension of coverage, as did the bipartisan 1998 National Commission on Retirement Policy convened by the Center for Strategic and International Studies (ACSS, 1997; NCRP, 1998). States with more than half their state and local employees not covered by Social Security include: Ohio (97 percent); Massachusetts (94 percent); Louisiana (72 percent); Nevada (70 percent); Colorado (68 percent); California (57 percent); Alaska (52 percent); and Maine (52 percent) (U.S. Ways and Means Committee, 2004). State and local governments that would be affected and their employee representatives have opposed this idea in the past. They would be required to pay Social Security taxes and, presumably, they would need time to modify their pension systems to fit with Social Security, as was done when Social Security coverage was extended to newly hired federal employees in 1983².

Raising the Age for Full Retirement Benefits

The age at which retirees can collect full Social Security benefits is now 65 years and six months for people born in 1940, who reach 65 in 2005. It is scheduled to rise to 67 for those born in 1960 or later. Raising the full benefit age will improve Social Security's long-range finances mainly because the change lowers benefits for retirees. For example, when the full benefit age was 65, benefits claimed at age 62 were reduced by 20 percent; when the full-benefit age reaches 67, benefits claimed at 62 will be reduced by 30 percent, while benefits taken at age 65 will be reduced by 13.3 percent.

Option #5

If policymakers speed up the increase in the full-benefit retirement age to reach 67 for those born in 1949 or later, and raise the age one month every two years until it reaches age 68 for people born in 1973 and later, these changes are estimated to remedy 28 percent of the long-range deficit. Under this change, when the full-benefit age is 68, benefits claimed at age 65 would be reduced by 20 percent and benefits claimed at age 62 would be reduced by 34.5 percent.

Option #6

Yet another option would continue to raise the full-benefit age to 70. If policymakers speed up the increase in the full-benefit retirement age to reach age 67 for those born in 1949, and then extend it one month every two years until it reaches age 70 for people born in 2021, these changes would eliminate 36 percent of the long-range shortfall. As a result of this change, the benefit reduction for early retirement would be larger. When the full-benefit age reached 70, benefits taken at age 65 would be reduced by 30 percent and benefits taken at age 62 would be reduced by 43 percent.⁴

Cutting Benefits Across the Board for New Beneficiaries

Benefit reductions across the board are another way to reduce the Social Security system's long-range deficit.

Option #7

If benefits were reduced by 3 percent for everyone newly eligible for benefits in 2005 or later, this change would solve 20 percent of the problem. This change would lower benefits for all new recipients, including retirees and their dependents, widowed spouses, disabled workers and their families, and families with children whose working father or mother died.

Option #8

If benefits were reduced by 5 percent for everyone newly eligible for benefits in 2005 or later, this change would solve 32 percent of the 75-year financing problem.

Price Indexing the Benefit Formula

Proposals to “price-index” the benefit formula provide for gradual reductions in the benefits payable to all new beneficiaries. Under current law, benefits for each successive cohort of retirees are indexed to keep pace with wage growth. The underlying idea is that benefits for new retirees will replace a constant fraction of lifetime earnings. Since the late 1970s, Social Security benefits have replaced about 42 percent of the earnings of a medium wage earner who retires at age 65. The replacement rate is slated to decline to 36 percent over the next two decades as the Social Security full-benefit age rises to 67. Benefits at age 65 will continue to replace 36 percent of previous wages for a medium wage earner who retires after the full-benefit age reaches 67.

Option #9

The President's Commission to Strengthen Social Security in 2001 recommended a plan to “price index” the benefit formula.⁵ In this particular plan, the percentages in the benefit formula would gradually be reduced. This change would reduce future benefits enough to make the Social Security system solvent for 75 years, as it would eliminate 111 percent of the long-range shortfall (OCAct, 2002). With this change, the level at which Social Security benefits replace retirees' prior earnings would decline in each future year. The benefit for a medium wage earner would be 10 percent lower than scheduled in current law for those claiming at age 65 in 2022; the reduction would be 26 percent for those taking benefits at age 65 in 2042. For age 65 retirees in 2075, the price-indexed formula change would produce benefits 46 percent lower than under current law (Greenstein, 2005).

Changing Cost of Living Adjustments

Under current law, Social Security benefits are automatically adjusted each year to reflect the increased cost of living. Some proposals would lower Social Security benefit costs by changing the way in which Social Security benefits are adjusted to keep pace with the cost of living. Some proposals would pay less than the full cost of living, for example, by adjusting benefits by the cost of living minus 1 percent, or minus $\frac{1}{2}$ of 1 percent.

Option #10

If the annual cost-of-living increase for Social Security beneficiaries were reduced by 1 percentage point, this change would solve 79 percent of the financing shortfall. If inflation were 3 percent a year, the annual increase for beneficiaries would be 2 percent for that year. This change would impose the greatest burden on the oldest beneficiaries because the reductions accumulate over time. For example, a 92-year-old beneficiary would have the purchasing power of her benefits eroded by 25 percent if the cost of living went up by 3 percent every year, but she received only a 2 percent increase each year.

Option #11

If policymakers were to reduce the cost-of-living adjustment by half a percentage point, the change would eliminate 41 percent of the long-range shortfall. In this scenario, a 92-year-old beneficiary would see the purchasing power of her benefits erode by 14 percent if inflation were 3 percent per year, but she received only a 2.5 percent annual increase.

Option #12

A different approach would shift to a new measure of the cost of living. Social Security benefits are now automatically adjusted by changes in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), as measured by the Bureau of Labor Statistics (BLS). The BLS has developed a new “chained” CPI. It differs from the CPI-W in that it takes into account purchasing substitutions (such as buying more chicken when beef prices go up) and reflects the fact that as the price of a particular commodity rises people change their spending habits – spending less on food, for example, in order to pay for gas. Because the “chained” CPI is expected to produce slightly lower cost-of-living adjustments, it is projected to shrink the long-run shortfall by 18 percent if it were used to adjust Social Security benefits. Proponents of this approach argue that it is a more accurate and up-to-date measure of the cost of living. Opponents worry that, even if it is more accurate, the slightly smaller adjustments will affect oldest beneficiaries the most.

Raising Social Security Taxes

Policymakers could consider raising the Social Security tax rate to help pay for future benefits. The impact of such proposals would depend on the size and timing of the change.

Option #13

If policymakers raised the Social Security tax rate immediately so that both workers and employers paid 7.2 percent instead of 6.2 percent of earnings, Social Security would be solvent for 75 years and beyond. This change would solve 104 percent of the problem. The medium wage worker, making \$34,700 a year, would face an immediate tax increase of \$347 a year, raising his or her taxes from the current level of \$2,151 to \$2,498. The em-

ployer would face an identical increase. A worker at the maximum wage base, \$90,000 a year, would have an immediate tax increase of \$900 a year, as would his or her employer. The annual tax paid by the worker and the employer would increase from the current level of \$5,580 to \$6,480. Because Social Security is running surpluses over the next decade and beyond, an immediate tax increase would add to the surpluses that are invested in Treasury securities and, in effect, loaned to the rest of the government.

Option #14

Policymakers could avoid adding to the near-term surpluses in Social Security by scheduling tax rate increases now that take effect in the future, when Social Security is projected to have a cash flow deficit. Future tax rate hikes scheduled in law have been a feature of Social Security since it began in the 1930s up through 1990. If policymakers scheduled a future tax hike for both workers and employers from 6.20 to 7.25 percent, to take effect in 2020, and another increase to 8.30 percent, to take effect in 2050, Social Security would be solvent for 75 years and beyond. These changes would solve 104 percent of the financing problem. Some analysts point out that future workers will be able to afford higher Social Security taxes to support the growing number of older Americans because wages are projected to grow in real terms (Thompson, 2005). By 2020, workers' real income from wages – that is, their purchasing power after incomes are adjusted for inflation – is projected to be about 19 percent higher than in 2005. By 2050, wages are projected to have 64 percent greater buying power than in 2005 (Board of Trustees, 2004). Other analysts worry that combined taxes of 14.5 percent or 16.6 percent are a large burden to put solely on wages.

Earmarking Other Taxes

Some analysts have suggested taxing wealth or income other than wages to help pay future Social Security benefits. The current Social Security tax base – wages up to \$90,000 a year – constitutes only about 39 percent of the nation's gross domestic product (GDP), a measure of total national income and product from all sources. Another roughly 10 percent of GDP is made up of wages above the \$90,000 tax cap and earnings of state, local and federal employees who are not covered by Social Security (Board of Trustees, 2004).⁶ Policy options to lift the \$90,000 cap or extend coverage to uncovered state and local employees have already been explored.

The other half of national income that is not taxed to help pay for Social Security includes: employee compensation in the form of employer contributions to fringe benefits, such as pensions and health insurance premiums that are not counted as part of employees' taxable wages; employees' tax deductible contributions to various cafeteria plans and flexible spending accounts (CCH, 2005); and income from property and wealth (as distinct from compensation for work), such as interest income, stock dividends, and rental income from real estate.

Option #15

Some have proposed earmarking a limited estate tax for Social Security. Under current tax law, the estate tax is being gradually reduced so that by 2009 it applies only to estates valued above \$3.5 million. Preserving the 2009 estate tax into the future and earmarking it for Social Security would solve about 27 percent of Social Security's long-range shortfall over the next 75 years. The proposal would apply a 45 percent tax rate on the portion of estates in excess of \$3.5 million. That tax is estimated to apply to about one-half of one percent of all estates – about 10,000 estates a year (Ball, 2004).

Option #16

Others have suggested that tax cuts enacted in 2001 and 2003 merit review in the context of restoring solvency to Social Security. An analysis by the Center on Budget and Policy Priorities in February 2005 estimates that the cost of the 2001 and 2003 cuts in federal income taxes, inheritance taxes, and in taxes on dividends and long-term capital gains – if made permanent – are three times the size of the long-range shortfall in Social Security finances. This finding is based on the Trustees’ estimate that the Social Security shortfall is about 0.65 percent of GDP, while the tax cuts (if made permanent) are 1.95 percent of GDP, according to estimates by the Congressional Budget Office and the congressional Joint Committee on Taxation. The Center further finds the cost of the tax cuts for the most affluent one percent of Americans (if made permanent) is about the same size as the entire Social Security shortfall over the next 75 years (Kogan and Greenstein, 2005).

Diversify Social Security Trust Funds Investments

Some have proposed a more diversified investment portfolio for the Social Security trust funds. Instead of investing 100 percent of the funds in special-issue Treasury securities, as called for in current law, part of the funds could be invested in equities. The effect on Social Security solvency will depend on investment returns that are actually earned.

Option #17

If fund managers placed 40 percent of the Trust Funds in equities – phased in between 2005 and 2019 – and those investments earned an historical 9.5 percent return (or 6.5 percent real return with 2.8 percent inflation⁷), this change would eliminate nearly half (48 percent) of the long-range deficit.

Option #18

If, instead, the same investment policy ended up producing a nominal return of 8.5 percent (or a real return of 5.5 percent on top of inflation), the policy would eliminate about one third (35 percent) of the long-range deficit.

Summary

Social Security is in strong financial shape in the coming decade. In 2004, the Social Security trust funds ran a surplus of \$156 billion, while the rest of the government ran a deficit of \$567 billion. Social Security funds are projected to cover all scheduled benefits through 2042, under the Trustees’ “best estimate” projections. At that time, earmarked taxes coming in are projected to cover 73 percent of promised benefits. If these projections hold true, it will be necessary to raise revenue or lower benefits at some point in order to balance finances over the full 75-year projection period. Revenue-raising options include lifting the cap on earnings subject to Social Security taxes, raising the Social Security tax rate, or earmarking other taxes for Social Security. Benefit reduction options include raising the full-benefit retirement age, reducing cost-of-living adjustments after retirement, or cutting benefits by price-indexing the benefit formula or adopting other across-the-board cuts. Creating individual accounts changes the form of Social Security, but does not improve solvency. In fact, to shift money from Social Security taxes to personal accounts would take away funds that are needed to pay scheduled benefits to today’s beneficiaries and those who will become beneficiaries in the near future.

Table 1. Options to put Social Security in financial balance for 75 years

Solvency Option	Percent of 75-year shortfall met
Raise the Tax Cap	
1. Make all earnings subject to Social Security taxes, but retain the cap for benefit calculations, beginning in 2005	116
2. Make all earnings subject to Social Security taxes and credit them for benefit purposes, beginning in 2005	93
3. Make 90 percent of earnings subject to Social Security taxes and credit them for benefit purposes, phase in 2005-2014	40
Extend Coverage	
4. Cover newly hired State and local employees, with a 5-year phase in	10
Raise the Age for Full Retirement Benefits	
5. Speed up the increase to age 67 and index the age to 68, by raising it one month every two years.	28
6. Same as #5, but index the age to 70 by raising it 1 month every two years.	36
Cut Benefits for New Beneficiaries	
7. Cut benefits by 3 percent for those starting to get benefits in 2005	20
8. Cut benefits by 5 percent for those starting to get benefits in 2005	32
9. Price Index the benefit formula	111
Change Cost of Living Adjustment (COLA)	
10. Lower the COLA by 1 percentage point each year	79
11. Lower the COLA by ½ of 1 percentage point each year	41
12. Shift to the new “chained” CPI	18
Raise Social Security Taxes	
13. Raise tax rate for workers and employers from 6.2 to 7.2 in 2005	104
14. Schedule tax rate for workers and employers, each, of 7.25 percent in 2020-2049 and 8.3 percent in 2050 and beyond	104
Use Other Taxes	
15. Earmark for Social Security the remaining tax on estates over \$3.5 million in 2010 and beyond	27
16. Instead of making 2001 and 2003 tax cuts permanent, earmark part of federal income taxes or capital gains taxes for Social Security after 2009	a/
Invest Trust Fund in Equities	
17. Invest 40 percent of trust funds in equities, phased in 2005-2014, assuming a 6.5 percent real return (over 3.0 percent inflation)	48
18. Same as #17, assuming 5.5 percent real return (over 3.0 percent inflation)	35

a/ Not a specific proposal.

Source: All estimates are from Office of the Chief Actuary, 2005c, except for #9, which is from the Office of the Chief Actuary, 2002, and #12 and #15, which are reported in Ball (2004) based on estimates by the Office of the Chief Actuary using 2004 Trustees’ assumptions.

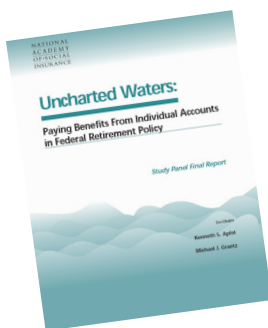
Endnotes

- 1 This Brief examines how various proposals affect the 75-year actuarial deficit in the Social Security trust funds. Another important question is how various changes would affect finances after the 75th year. If financial status is declining at the end of the projection period, then proposals that remedy the 75-year actuarial deficit in 2005 could end up showing a 75-year deficit a few years out -- for example, in the 75-year period starting in 2010. Future NASI fact sheets will discuss measures of solvency beyond the summary actuarial balance (deficit or surplus) over 75 years.
- 2 The full retirement age for a person born in 1940 who retires in 2005 at age 65, is 65 and 6 months. Therefore this benefit amount is reduced slightly due to early retirement.
- 3 Following the 1983 legislation, a new Federal Employees Retirement System was set up to supplement Social Security coverage for newly hired federal employees. Employees hired before 1984 could elect to join the new system and be covered by Social Security or to remain in the older Civil Service Retirement System. The number of federal employees not covered by Social Security is gradually declining.
- 4 The reduction in benefits is 6.7 percent per year for the first three years before the full-benefit age, 5 percent per year for the next two years, 4.5 percent for the next two years, and 4 percent thereafter (OCAct, 2005d)
- 5 The proposal would lower replacement rates for retirees each year after 2009 by the difference between wage growth and price growth.
- 6 The tax base for Hospital Insurance under Medicare is about 49 percent of GDP, 10 percentage points more than the Social Security tax base because it includes earnings above the cap that applies to Social Security taxes; it includes more federal, state and local employees who are not covered by Social Security; and it includes railroad employees who pay into their own pension program instead of Social Security.
- 7 The nominal rate of 9.5 percent reflects a real return of 6.5 percent and inflation of 2.8 percent, such that $1.065 \times 1.028 = 1.095$.

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Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy, Study Panel Final Report, January 2005. Michael J. Graetz, Kenneth S. Apfel, co-chairs. National Academy of Social Insurance, Washington, DC, January 2005. 225 pages, \$29.99. To order call (202-) 452-8097 or email nasi@nasi.org.

This report considers some of the payout issues that might arise from implementing a system of individual accounts, if such accounts were to become a part of federal retirement policy. Why is it important to examine "payout" issues? Because a central goal of retirement security policy is to assure some level of adequate income, it is essential that any debate about creating individual accounts include a complete understanding of how the benefits will be received.

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